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SUBJECT: MEXICO FACES BUDGET CHALLENGE; TAX HIKES, SPENDING CUTS LIKELY

Summary

¶1. (U) The Calderon administration faces a formidable challenge in preparing its 2010 budget. GDP contracted 10.3% in the second quarter of this year, the fourth consecutive quarter of decline. Weak tax collection, the recession, and low oil production, prices, and exports has created a 2.7% of GDP spending gap for 2010. The President plans to propose austere measures which may include a combination of debt, higher taxes, and lower spending. The Administration is confident there are sufficient political incentives in place to approve successful fiscal reform. Despite the GOM's confidence, the outcome of the reform depends largely on the willingness of the PRI to agree to these politically unpopular tax changes. End Summary.

GDP Contraction in 2Q09

2.(U) On August 20, Mexico's statistics agency (INEGI) reported a 10.3% GDP contraction in the second quarter, compared to the same quarter last year. Hurt by a slowdown related to the H1N1 flu outbreak and the Easter holiday, it is the fourth consecutive quarter of declines in economic activity. According to the agency, a 16.4 percent contraction in manufacturing and a 9.2 decline in construction led the quarterly decline. Commerce was down by 20.9 percent and transportation decreased by 13.7 percent. The decline is slightly less than analysts, projections. Undersecretary of Finance Alejandro Werner told the media that the economy stabilized or touched bottom in June 2009; he projects a recovery in the next quarter. Werner also noted improving July data for car sales and unemployment figures were the first evidence of a recovery. (Note: The OECD reportedly advised Mexican policymakers to ensure the economy stopped contracting before tightening fiscal policy. Hasty moves to bring public finances back in balance could aggravate the recession. End note.)

The Fiscal Challenge

3.(U) The GOM must send its 2010 budget to Congress by September 8. In preparing its 2010 budget, the GOM faces a spending gap on the order of MX$300bn (approximately US$23bn or 2.7 percent of GDP, assuming a 7.5 percent annual contraction this year). The gap is due to continued:

-- Low oil production, prices, and exports. About 35-40% of budget revenues depend on oil. Oil production has fallen by almost 800,000 bpd (or 25%) since Calderon took office in December 2006, with production at Mexico's main oil field, Cantarell, down more than 50% since it peaked in 2004. Oil revenues in the first 5 months of 2009 were down 24 percent compared to the same period in 2008. The GOM also forecasts an average export price of US$54/b in 2010, down from US$70/b in 2009.

-- Weakness in collecting taxes. Non-oil taxes represent less than 10% of GDP, compared to an average of 19 percent internationally and 15 percent in Latin America. Tax collection has historically been difficult in Mexico, and a recent tax reform that raised taxes on business has stagnated.

-- Decline in economic activity due to the recession. Fully integrated into the U.S. economy, the Mexican economy is reeling from the U.S. economic crisis, which takes over 80 percent of Mexico's exports. Mexico's trade was down by a third in the first half of 2009, year-on-year. Last month Secretary of Finance Agustin Carstens said that the economic crisis had cut the GOM's revenues by MX$480bn (US$36.6bn).

Austerity Package on the Way

¶4. (U) In a bid to keep a lid on next year's budget gap, President Calderon recently indicated the GOM's intention to launch a "very severe austerity plan which will probably

include adjustments to the very structure of the government." The GOM's proposal may include a combination of debt, higher taxes, and lower spending. Other possibilities include expanding the tax base to the informal sector, changing current energy pricing policies, and simplifying the tax system. (Comment: The proposal to selectively expand the value-added tax (VAT) on medicines and food is controversial. End Comment.) The GOM has already cut spending twice this year (a combined 0.7 percent of GDP) and also plans to use profits on dollar/peso operations and oil and state-revenue stabilization funds to plug the gap for 2009.

Prospects for Fiscal Reform

¶5. (SBU) The Finance Secretariat and the central bank (BOM) remain confident that there are sufficient political incentives in place to approve a successful fiscal reform. Despite this confidence, the outcome of reform efforts depends greatly on the willingness of the opposition and lower house majority coalition (PRI-PVEM) to agree to these politically unpopular tax changes. In a meeting with a group of visitors from the Office of the Comptroller of the Currency on August 19, Victor Herrera, the chairman of Standard & Poor's (S&P) in Mexico, expressed his doubt that any major fiscal reform would be approved. Taking a lame-duck view of the last half of Calderon's term, he said some small reforms would be passed, but nothing significant. He explained that it was not in the PRI's interest to make Calderon look good. At the same time, the PRI needs to show that it is being somewhat cooperative by passing small reforms, but nothing that will have a major impact. Other observers say the PRI wants to build on its 2009 electoral victory and get credit for improving the economy before the 2012 Presidential election.

6.(SBU) Herrera also implied, but did not explicitly state, that S&P will probably downgrade its rating for Mexico. The line that gave it away was when Herrera described Moody's recent rating affirmation as &bold and aggressive.8 Nevertheless, the downgrade is unlikely to have a &negative outlook8 attached. In S&P's opinion, the economy will

improve by 2012. (Comment: Before the economic crisis hit, Fitch put Mexico on a negative watch last year. Given that the economy has deteriorated since then, Fitch will downgrade as well. End Comment.)

Security Spending Constant

¶7. (SBU) Calderon's top priority is the counternarcotics campaign; in spite of potential expenditure cuts in other areas, Standard & Poor's Victor Herrera said security spending would remain constant in the GOM's proposal. (Note: GOM Cabinet members have confirmed this steady state security spending in multiple conversations with the Charge.) He emphasized to Econoff in a meeting that funding to states and municipalities would be cut before security. When questioned whether the PRI would try to negotiate for more funding to states and municipalities in the run-up to 2012, Herrera responded that the PRI has a reputation of being the most infiltrated by the cartels so they would not want to take any actions -- like cutting security -- that would hurt their presumed candidate's (State of Mexico Governor Enrique Pena Nieto) squeaky clean image. Sigrid Artz, Former Technical Secretary to Mexico's National Security Council, echoed a similar view to Econoff last month) but said the PRI would try to negotiate a change in the composition of security spending, with more resources going to state and municipal public security programs such as SUBSEMUN (a federal grant to municipal law enforcement entities).

Comment

¶8. (SBU) Recession and falling oil production have put the GOM's fiscal accounts in a vulnerable position. One-off measures will allow the GOM to maintain fiscal control during ¶2009. However, there will be a fiscal gap of 2.7 percent of

GDP in 2010 -- 4-5 percent of GDP including Pemex infrastructure investment -- unless the Calderon administration reaches a substantive fiscal restraint agreement with the new Congress. It is unclear whether domestic investors, particularly international capital markets, would be willing to finance this without a significant premium.

¶9. (SBU) Meanwhile, PRI Mexico State Governor and possible Presidential contender Enrique Pena Neto told the Charge on August 21 that, while the PRI was considering how it might collaborate with the government to solve the country's dire economic crisis, it was carefully considering the &political costs8 of such cooperation. Pena Nieto made clear that the PRI was ready to cooperate, but intends to secure significant compromises on its priority issues. The GOM's challenge) far more difficult than it concedes) will be to structure its economic measures in a way that will bring the PRI on board. End Comment.
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